DOW THEORY LETTERS INC.

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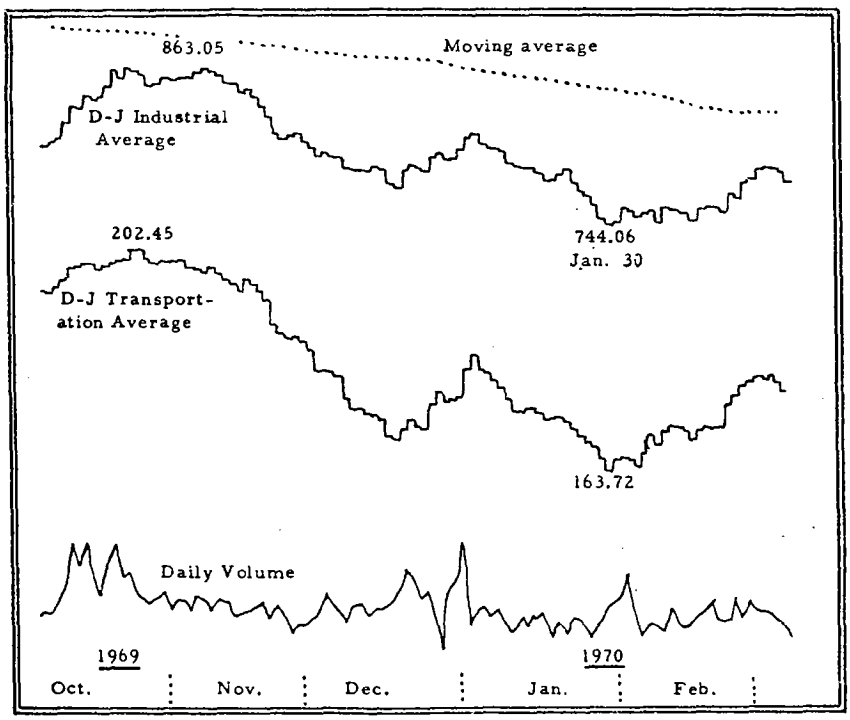
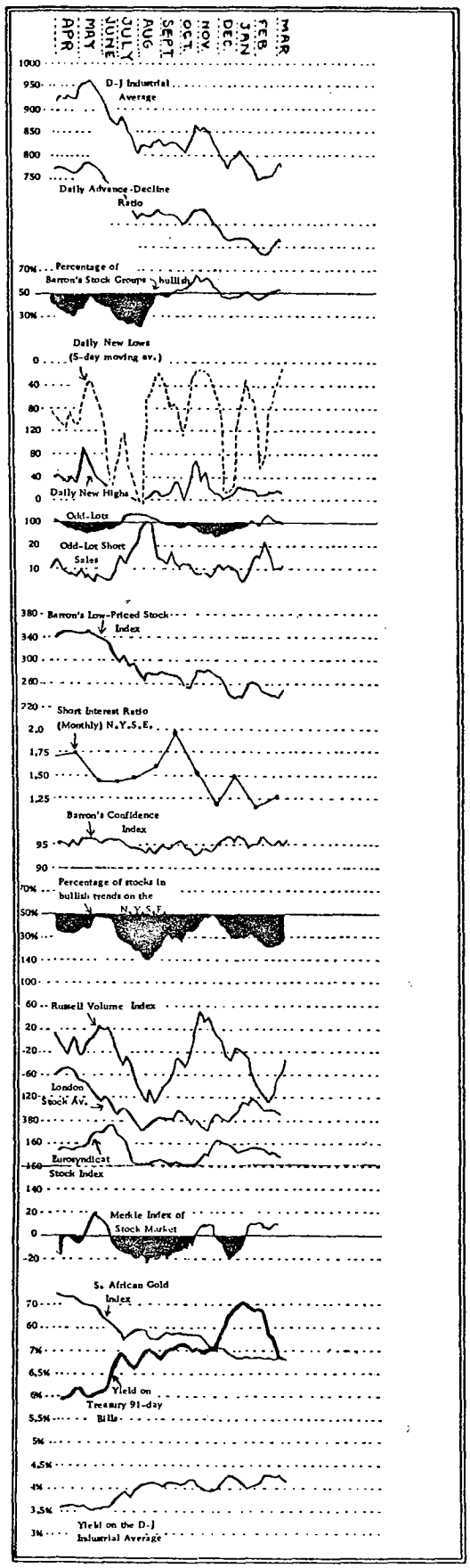
THE MARKET: In the last few Letters I pointed out that although the duration and extent of the 1969-70 collapse would appear to call for a sizeable rally from this area, a number of negative indications cause me to wonder whether any rally at this time will not be a "fooler". I pointed out in Letter 453 that odd-lot short sales were totally unsatisfactory for a major advance. In Letter 454 I noted that no major advance had ever come from an area where the short interest in the Dow Industrial stocks was under 1.0. Nevertheless, investment advisors almost to a man are now promising that the January low of 744.06 for the Dow was an important bottom; further, they are now predicting a major advance from this area.

Frankly, I am skeptical. In the absence of a high-volume, frightening selling climax, in the absence of good odd-lot shorting, with the Dow short interest ratio at current extremely low levels, I would rather skip this "great advance" even if I did advocate playing (or should we say "scalping") against the primary trend. Those who jump in here are ignoring the fact that they are trying to beat what could be one of the most drastic primary bear markets in a generation. I urge my subscribers to adhere to the policies which have kept us from sustaining losses in this bear market so far. Let the gun-slingers sell stock to each other during this bear market. In my opinion we are coming closer and closer to the time when cash will be king.

All over the nation corporations, cities, counties and states (and Uncle Sam) are lining up for new issues and more money. Offerings of corporate debt securities this month may go over $2 billion, a record. In April the total may go even higher if we include AT & T's mammoth plans. Billions in bonds are coming to market and other billions have been cancelled and are there awaiting "a better market." The astounding pile-up of money needs are calculated to make a

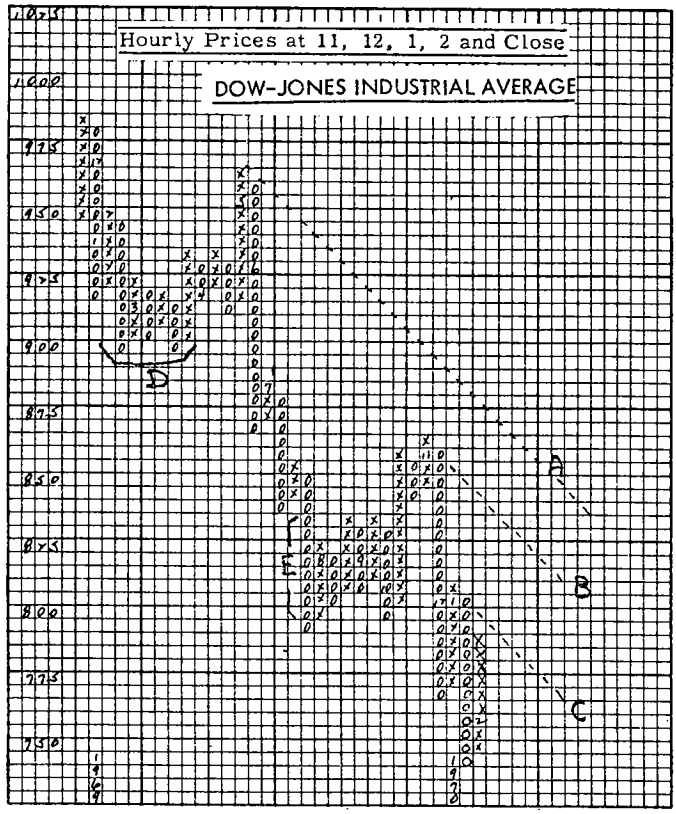




mockery of the recent little bond rally, and I would guess that before 1970 is out the stock and bond markets will be exhausted as they attempt (I think unsuccessfully) to cope with the endless huge supply of offerings.

Each primary bear market is different, and each has its secret bag of problems and disasters which investors "didn't see" until it was too late. This bear market shapes up as a major and fearful confrontation with the whole American philosophy of "Buy now, pay later." I'm not preaching morality at this point. I'm simply offering the opinion that "Pay later" is rapidly reaching the point of "Pay now--but with what?"

POINT & FIGURE: I believe that a P & F study of the current position of the Dow Industrials should be instructive at this time. This is a 5-point, 15-point reversal chart (courtesy of Chartcraft, Larchmont, N.Y.). Each box represents 5 points on the Dow and only rallies or declines of 15 points or more are shown. The chart covers all the action on the Dow since the December, 1968 peak of 985.21. The X's on the chart signify rallies of 15 points or more, the O's signify declines of 15 points or more.



The last extended vertical row of O's began in January, 1970, and this decline terminates at the 745 box. There a number of interesting phenomena show on the chart. First, it is important to note that the current rally has sprung from no visible base at all. The Dow simply sank to the 745 box, then rallied straight up (without building even a temporary base such as the 1969 base which is marked D on the chart). As a rule, no extended or worthwhile rally will result from a simple reversal such as the one which occurred at the January low of 745.

Of course, it is possible that a series of rallies and declines from here will ultimately result in a good base, but this would take much more time and effort. As matters now stand, suffice it to say that no base has been built. Such a rally (stemming from no base) is characteristic of a short-covering, news-inspired rally in a bear market, rather than an authentic advance within a bull market.

Next, note that I have drawn three declining or bearish trendlines. The first, closest and least important is trendline C, which intersects the Dow at this time at the 800 level. This trendline should prove an inhibiting factor for any rally above 800. The second trendline (marked B) extends from the November, 1969 peak of 863.05 on the Dow. This trendline is of considerable more importance than trendline C. Trendline B intersects the Dow currently at the 845 box.

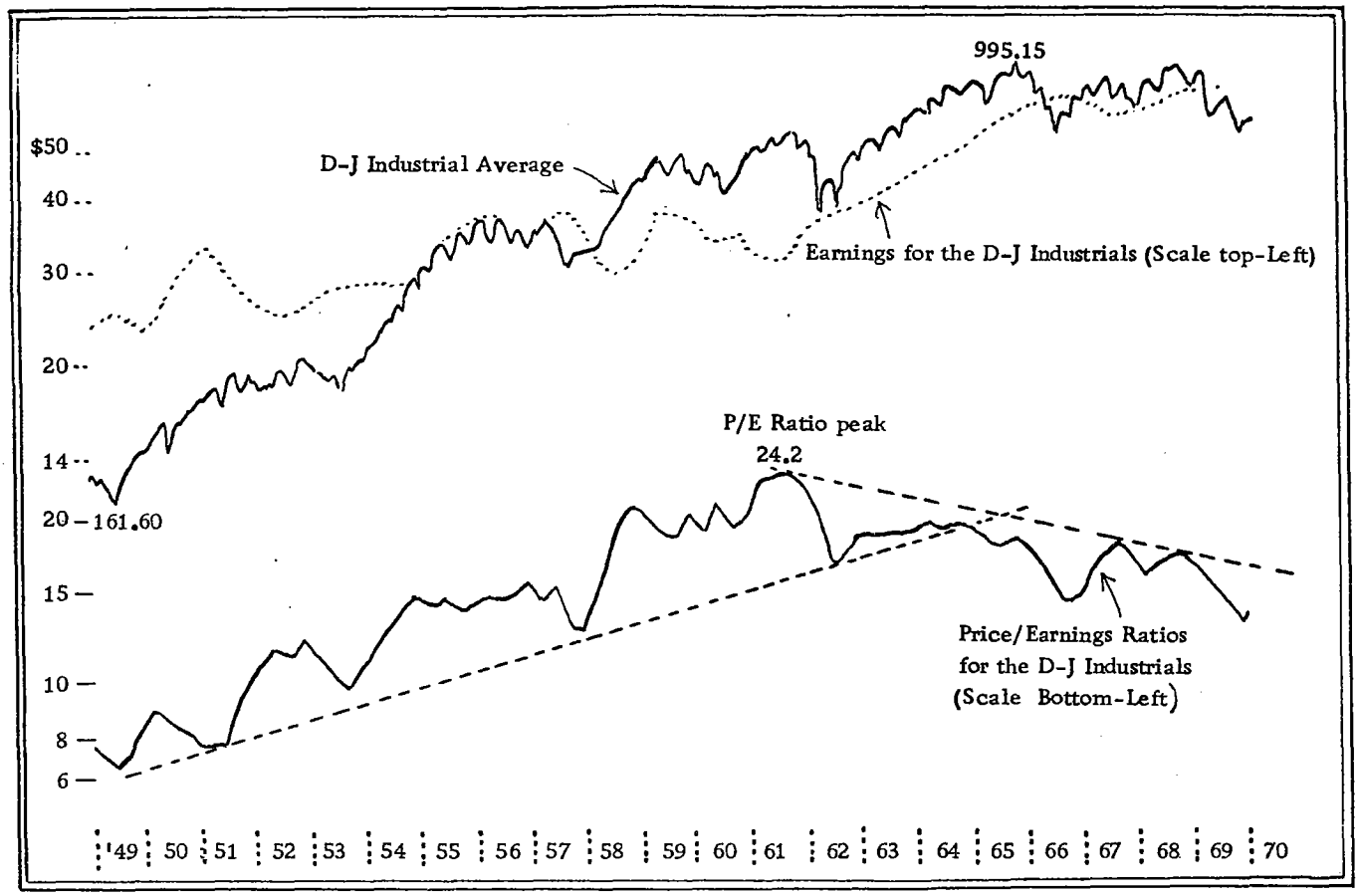
Finally, the most important bearish trendline (marked A) extends downward from the May, 1969 peak of 968.85. This long-term trendline intersects the Dow currently at 875.

Thus we have three good trendlines with which to measure the power of the Dow on the upside.

Worth commenting upon also is the last "box" of distribution, which I have marked with an E on the chart. This pattern occurred in the 800 to 835 zone on the Dow. The breakout above this 800-835 zone in October, 1969 proved to be a "fooler," and the Dow subsequently plunged below 800. Thus, the whole 800-835 zone remains an area of overhead supply, and according to the chart it should take heavy buying to push the Dow up through the 800-835 area.

All of this will be worth studying if and when the rally carries above the first or C trendline or into the area above 800. Of interest at present is the face that only 8 of the 30 Dow stocks are now bullish on a P & F interpretation. A good many more of the Dow stocks are going to have to turn bullish if this rally is to progress anywhere above 800. The bullish percentage of Dow stocks will be discussed in future Letters.

P/E RATIOS AND SENTIMENT: The primary bear market began on February 10, 1966. In duration the bear market has now lasted slightly over four years. On a closing basis (Dow Industrials), the total Dow loss from the 665.15 high of Feb. 9, 1966



to the 744.06 low of January 30, 1970 was approximately 25%. Thus the depreciation in the average Dow Industrial stock (not taking dividends into account) has been about 6% per year over the four years, hardly a drastic performance for a primary bear market. Although earnings have not risen appreciably for the Dow stocks since 1966, dividends have increased on average from the $31.89 total payout of 1966 to the $33.90 payout of 1969.

Thus, although earnings have held fairly steady and dividends have actually trended higher, the Industrial Average four years after the 1966 peak finds itself still 200 points under the high. What has changed?

I have drawn a chart which provides a good deal of the answer. This chart shows the Dow Industrials, the earnings (monthly, on a 12-months ended, basis), and the price-earnings ratio (also monthly, on a 12-months ended, basis). Now here is the fascinating thing. Note that from 1949 to 1965 both earnings and P/E ratios trended higher, with the obvious result being that the Dow hit successive new highs.

During the third quarter of 1961 the peak of optimism was recorded, and it was here that investors paid 24.2 times earnings for the Dow. That was the peak of bullishness in terms of P/E ratios for the Dow. Then during 1962 and thereafter P/E ratios came down rapidly— even though actual earnings continued higher! What was occurring? Investors were lowering the multiples they were willing to pay for Dow earnings. Nevertheless, the rising trendline of P/E ratios held all during the early 1960's.

Then during late-1965 and early-1966 the P/E ratio trendline was reversed. This was the spot where long-term sentiment, in terms of P/E ratios on the Dow, reversed to the downside. A year later, in February, 1966, the Dow Industrial Average hit its bull market peak of 995.15. Earnings were still moving up. But the trend of P/E ratios was declining. In other words, the peak of investors bullish sentiment towards the Dow occurred in 1961. The reversal of the whole bullish trend in P/E ratio occurred in 1965.

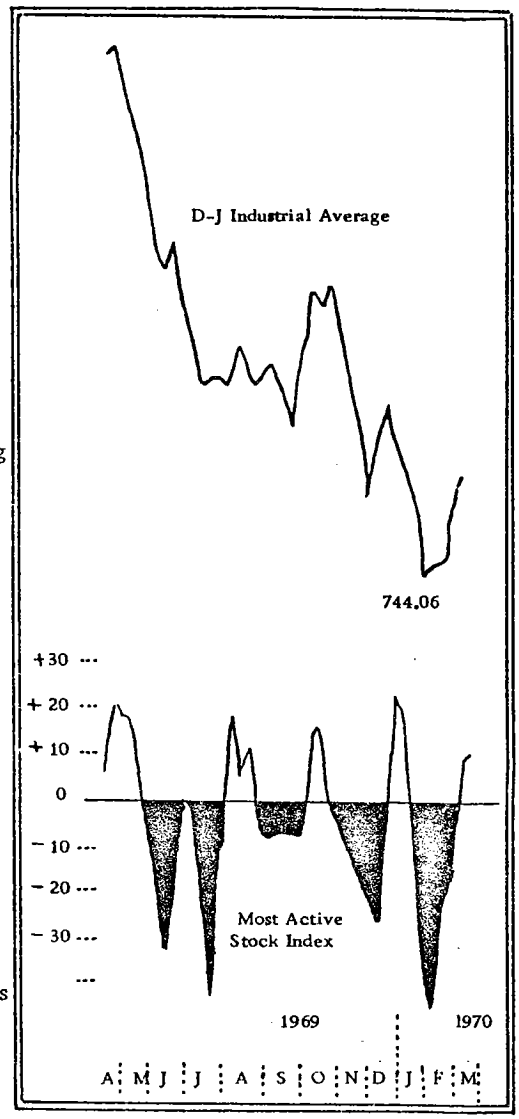
The important thing to realize now is that there is a cycle of investors' sentiment, from the early beginnings of bullish sentiment (with low P/E ratios) when a bull market begins to a high degree of bullish sentiment (high P/E ratios) as a bull market reaches maturity. Then as a primary bear market starts the trend of sentiment gradually turns bearish and P/E ratios (as they are now) start their long trend down again.

While this bear market is on we should also realize that one of two factors, or both, can drive the Dow to new lows. Either earnings must fall or sentiment must blacken (producing lower P/E ratios) or both may occur. It is my belief that we are currently in a long-term pattern of both lower earnings and gradually dampening sentiment.

For comparison purposes, we should know that the lowest P/E ratio recorded for the Dow during the 1969-70 decline was the 12.5 of February, 1970. But studying the chart we note that during the second quarter of 1949 (this is where the 1949-66 bull market began) the P/E ratio for the Dow was 7. That P/E ratio is about 45% under the current figure. Will the Dow ever sell at 7 times earnings again? My guess is that before this bear market is over we will again see the Dow selling in the neighborhood of 7 or 8 times earnings.

MOST ACTIVE STOCKS: This is a study which was first presented in Letter 447. Each week the 20 most active stocks on the N.Y.S.E. are listed in various financial publications. It takes big money to land a stock on the most active list, and the direction (i.e., on the buy or sell side) is usually significant.

The direction of the most actives during any single week may not be significant but if we arrange the statistics in the form of three-week pleuralities the trend as shown on a chart is usually important. For example, if during a three week period 40 stocks advanced and 20 declined, we would have a pleurality of plus 20, and therefore a plus 20 would be entered on the chart. If, during the next week the three-week statistics showed 35 stocks advancing and 25 declining we would have a plus 10 pleurality, and a plus 10 would then be entered on the chart.



The chart shows the last year of action for the most active list, and it is interesting to note that 1969 was the first year since 1949 in which the most-active index spent the majority of its time below zero. To me that means that 1969 produced more downside activity than any year since the great bull market began in 1949.

So far in 1970, the index has shown five plus weeks and five minus weeks. The low for the index was minus 46 on the week ending January 3, and that was also the extreme low for 1969-70. On the week ending February 20 the index showed a plus 3, and on the week ending February 27 the index climbed to a plus 8. On the latest week ending March 6 the index rose to plus 10. Significantly, however, the latest weekly figure showed 7 of the most active stocks advancing, 13 declining for a weekly (not an index) figure of minus 6. Thus 6 more of the most active stocks declined than advanced, and this with the Dow up 6.53 points for the week. This could be the beginning of weakness for the rally.

SNOW IN THE ALPS: Last year the U.S. ran a $7 billion payments deficit, the largest in history. No one knows what this year's payments balance will be, but it is almost certain that it will again be on the deficit side. Balance-of-payments deficits imply many things, but one thing they definitely imply is a continued build-up of dollars in foreign hands. During 1969 interest rates in the U.S. were sky-high, and this meant that those who held dollars (and of course this included foreigners) were treated to the greatest return on the dollars they held in 100 years. Eurodollar (dollars held in Europe) interest rates of up to 12% were a tremendous incentive to hold those dollars, rather than turn them in for gold.

But what would happen if interest rates came down? Traditionally, European Central Banks put a limit on the amount of dollars they will hold. Their dollar balances were much higher than normal during the days of President Johnson, mainly due to constant "arm-twisting" by the Johnson Administration. Under President Nixon, this arm-twisting has largely ceased. There is little doubt, therefore, that if interest rates really decline the dollars will start being turned in for gold.

The February 24 Wall Street Journal carried an article which drew attention to the dangers of declining interest rates. The article was entitled "Whither the Dollar?" in that article one U.S. strategist stated, these dollars abroad are like "snow piled up in the alps. There's nothing to worry about as long as it stays cold. But if the thaw comes too quickly, there could be an avalanche." He explained that foreign Central banks now hold a whopping $12.6 billion in dollars, all of which are eligible to draw against the U.S.'s $10 to $12 billion gold hoard. Foreign individuals, banks and businesses hold an additional $29 billion, and if part of this $29 billion moves out of dollars (into foreign currencies) the Central Banks will be under massive pressure to start turning in new dollars for gold.

Even as the Journal article was written interest rates were sagging slightly, as witnessed by the drop in 91-day Treasury bills from interest rates of over 8% to the present 6.8% range. Simultaneously, the gold stocks began moving up. The danger flags were just beginning to wave again.

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On another (connected) front money problems continue to confront the U.S. and its planners. In a study in the March 9 issue of U.S. News & World Report it was stated that the "White House nightmare" is the spending that can't be cut. Half of the federal budget, the article states, goes to various programs that can't be reduced, programs in which spending is already committed under laws approved by Congress. The estimate is that 1970 will require $87.3 billion for these programs (against $77.1 billion in 1969). In 1971 the programs will require $95.1 billion, and in 1972 the figure will jump to $104 billion - or $27 billion beyond the 1969 figure.

In view of this, is it any wonder that President Nixon is trying to end the Vietnam war, cut back military commitments all over the world and close down U.S. military installations wherever possible?

Some of these "uncontrollable" expenses include veterans' bonuses, social security, joint federal-state project, medicare, pensions for Government workers, federal aid to the needy, interest payments on the national debt, etc.

With built-in expenses roaring ahead at this rate, I wonder what will happen as the primary bear market moves on, ultimately slowing business, cutting corporate profits and individuals' income, and then eating into federal tax receipts. This is the reason for my skepticism regarding the widely-announced peak in interest rates. With Government expenses climbing and a bear market eating into profits and income, the Administration is ultimately going to be faced with huge and frightening deficits. When that happens, the Treasury is going to have to come into the money market to make up expenses. That desperate Government move is going to send the bond market to its final bear market lows.

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My friend Irving Weiss of Capital Advisors in New York estimates that private credit expansion during 1969 rose $113 billion to a grand total of $1.25 trillion. This private credit includes trade credit, mortgages, bank loans, corporate bonds and commercial paper. The huge mountain of credit inflation hangs over the economy like a cloud and prevents any drastic drop in interest rates.

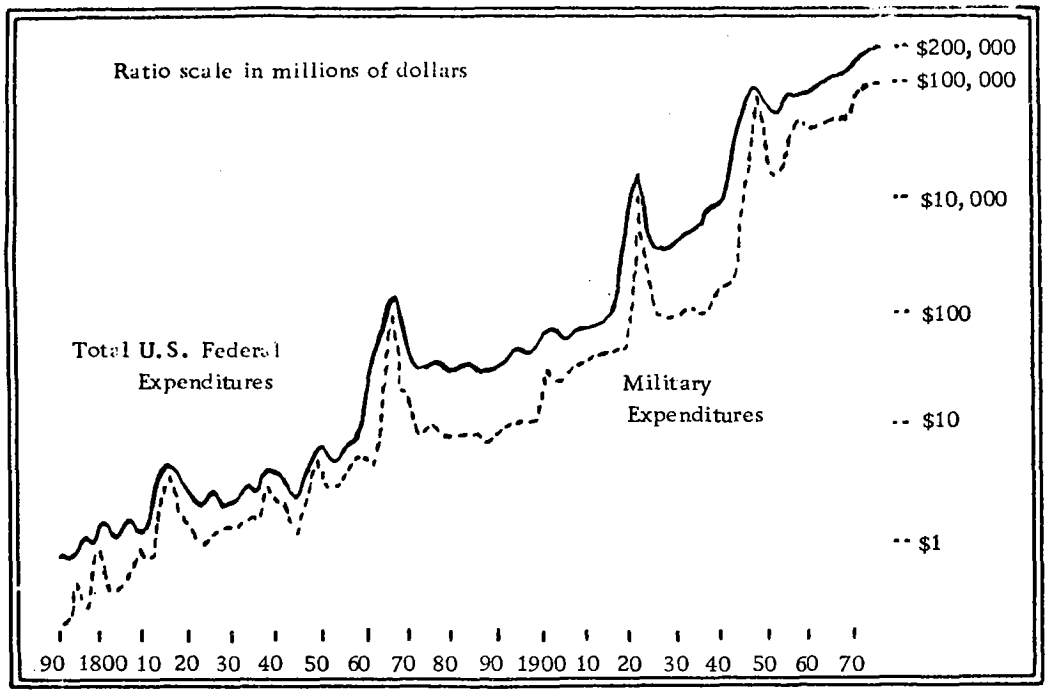
This year loans at the major banks have dropped $6 billion against a $7 billion rise last year. As Alden Wells points out in his latest report, "When profits are declining and corporations are illiquid, as they are now, managers will not be interested in adding to debt, but in getting liquid." He notes that there are three methods of doing this: Issuing long-term bonds, selling more stock or cutting dividends. We are seeing all three of these mechanisms at work now. We will undoubtedly see alot more of this type of activity during 1970.

ARMS AND THE BUDGET: On Page 6 I include an interesting little chart I drew up showing the relationship between total U.S. Federal expenditures and U.S. military expenditures. It is a ratio or percentage chart. The further apart the two lines, the less military expenditures show as a percentage of total expenditures.

It is clear that at present and for years military expenditures have absorbed about half of all Federal expenditures. I have claimed for some time that this is not only immoral but wasteful and practically insane. I live in a town which contains some of the great military installations in the world. I have talked to many military men, and I have heard one story over and over. The waste in the military is breathtaking and ridiculous. Often, the Navy is working unknowingly on the same project that the Army is working on. Often entire projects are put into effect at about the time they are already obsolete.

Up to a year or so ago, no questions were asked regarding needed military purchases. Now, questions are being asked galore. A year or so from now I feel that military plans will not only be quizzed, they will be shelved wholesale because this nation cannot afford to spend what it has been spending on military hardware. The U.S. and Russia, since World War II, have armed the world to the teeth. The race threatens to take both runners and all competitors over the cliff.

NOTE: Please read the Special Announcement regarding subscription price changes to take effect shortly. Although the subscription price of Dow Theory Letters is being advanced, I feel I have taken special, fair care of all my current subscribers and trial subscribers. Therefore, I ask you to read the Special Announcement carefully.


Ratio scale in millions of dollars
$200, 000
$100, 000
$10, 000
$100
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Total U.S. Federal Expenditures
Military Expenditures
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The following letter comes from my friend John McFalls whose presentation, "The Background & Implications of THE GOLD RUSH of 1968", was delivered at the 1968 International Monetary Seminar in London. Mr. McFalls is owner of Value-Action Advisory, a private counseling firm of 3838 48th Ave., N.E., Seattle, Washington 98105.

Richard Russell's DOW THEORY LETTER 452, dated February 6, 1970, contained a chart providing our estimates of the price/earnings ratios and current yields for 25 South African gold mines; also, our estimates of future earnings and relative profit potentials in the event of a doubling in the price of gold.

This chart first appeared in our copyright report published last November carrying the warning: "Squeezed by rising production costs and a drop in the market price for gold, most mines have lowered their earnings projections, the damage being most severe in those highly-leveraged companies which stood to gain the most from a doubling or a tripling in the price of gold."

This warning was most appropriate in view of the continuing drop in the earnings of those marginal mines reviewed in the February issue of the "Quarterly Review of South African Gold Shares" now available from The Mining Journal Ltd, 15 Wilson Street, Moorgate, London E.C.2, England. Annual subscription to QUARTERLY is $18.25.

For those seeking to outmaneuver the Finance & Investment Houses, I plan to update the November, 1969 study of individual companies and will be glad to provide you with a copy of this timely review on receipt of your check for $5.

STOCKS: Even as the rally progressed, Wall Street was a bit schocked to see their prime glamor favorites coming "unglued." Instead of leading the rally, as expected, the glamors were subject to vicious bear market action, while the previously hard-hit cyclical stocks rebounded from their depressed lows. Primary bear markets are democratic in that ultimately everything is leveled, first selectively and finally all together.

Charts courtesy of Quote Digest, 403 N. Main, Wichita, Kansas 67202